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Date:

September 20, 2006

Legend

Taxpayer =

State A =

Crops =

Dear :

This is in response to a request for rulings dated January 13, 2006, and subsequent correspondence, submitted on behalf of Taxpayer by your authorized representatives. The ruling concerns the application of subchapter T of the Internal Revenue Code to a transaction described below.

Taxpayer was incorporated on _____, under the Nonprofit Cooperative Association provisions of the Agriculture Code of State A. Taxpayer was organized and operated as an exempt farmers' cooperative under § 101(12) of the Internal Revenue Code of 1939, and subsequently treated as a tax exempt farmers' cooperative under § 521 of the Internal Revenue Code of 1986. Taxpayer has filed its federal information returns on Form 990-C.

Taxpayer's historic business activities consisted of marketing and processing Crops grown by its members. Taxpayer has never processed or marketed Crops of nonmembers. Taxpayer has conducted its business activities on land conveyed to it in _____ by a local government for no consideration. The buildings and improvements on this land were constructed by Taxpayer in or around _____. All of the buildings and equipment have been fully depreciated and have an adjusted basis of zero. The land, the buildings, and equipment are collectively referred to as the "Remaining Real Estate

Assets.” The equipment is referred to as the “Remaining Personal Property Assets.” The Remaining Personal Property Assets and the Remaining Real Estate Assets are collectively referred to as the “Remaining Operating Assets.”

In _____, Taxpayer entered into a lease granting a tenant a _____ year possessory interest in approximately _____ % of Taxpayer’s land (the Leased Premises). The lease did not affect Taxpayer’s ability to conduct its cooperative business activities. Until Taxpayer ceased operations in _____, Taxpayer’s rental income (including lease income from the Leased Premises) constituted significantly less than _____ % of Taxpayer’s total income. The rental income from the Leased Premises, and less than \$ _____ per year of other incidental rental income, was Taxpayer’s only income other than income from processing and marketing the Member’s Crops.

Pursuant to Section 4, Article V of the Articles of Incorporation (the Articles), Taxpayer has the power to retain some portion of the proceeds from the sale of each member’s Crops based on the weight of the Crops processed and marketed for that member (Retains). The Retains were in addition to the cost of processing and marketing the Crops, and were used as a reserve to ensure that Taxpayer would be able to continue operations in an economic emergency. These Retains were required to be included in the income of members by each member’s grower’s contract. Retains were returned to members over a _____ year cycle (e.g., Retains from _____ Crops were returned to member in _____). In _____, Taxpayer stopped collecting retains from the members and accelerated its return of Retains so that all the Retains were returned to the members by _____. From _____ through _____, Taxpayer processed and marketed Crops without collecting Retains.

As a result of discussions between Taxpayer and another farmers’ cooperative (Coop 2), Taxpayer permitted Coop 2 to begin processing and marketing some members’ Crops in _____. When a member delivered Crops to Coop 2, Taxpayer did not receive any payment for processing or marketing the Crops. Members were able to deliver Crops to either Taxpayer or Coop 2 through the _____ harvest.

In _____, prior to the harvest, Taxpayer’s board of directors determined the members would not deliver enough Crops that year to support Taxpayer’s continued operations. Based on that determination, Taxpayer did not process Crops in _____. As a result of Taxpayer not processing Crops, in _____ all the members delivered their Crops to Coop 2. In the period from _____ until _____, Taxpayer did not conduct business but used this period to determine whether the services provided by Coop 2 would be adequate and acceptable to all the members.

In _____, Taxpayer’s board of directors determined the services of Coop 2 were adequate and began to consider possible allocations for liquidating distributions and tried to sell its Remaining Operating Assets. Taxpayer had its Remaining Operating Assets, appraised in _____ and listed the Remaining Operating Assets with a realtor.

Taxpayer received one offer to purchase its Remaining Operating Assets in [redacted]. Taxpayer declined that offer because the offer price was significantly less than the appraised value.

In [redacted] the real estate market had declined and Taxpayer's board of directors decided to hire a realtor to help sell the Remaining Operating Assets. After discussion with several realtors, and slow progress negotiating a sale without a realtor, Taxpayer hired a realtor in [redacted]. After the Remaining Operating Assets had been listed with the realtor for a few months, the board voted to reduce the asking price. In [redacted], the board fired its attorney and in [redacted], Taxpayer's representative began advising the board about the tax consequences of the sale, the required formula for the liquidating distributions, and how to address the requests from members about the liquidating distributions. By [redacted], Taxpayer received two offers. Taxpayer made counter offers in [redacted] and entered in the Property Purchase Agreement on [redacted]. The members approved the sale in [redacted], and the sale closed on [redacted].

Continuously since Taxpayer stopped processing Crops in [redacted], members have been able to deliver Crops to Taxpayer for pick up and processing by Coop 2. Storage bins are maintained on Taxpayer's land pursuant to an oral agreement between Taxpayer and Coop 2. The activities at the drop off point are provided by an employee of Coop 2. The Coop 2 employee first grades the quality of the Crops delivered by the members. The Coop 2 employee then sorts the Crops into separate bins based on the grade and the identity of the member that delivered the Crop. Finally the Coop 2 employee maintains and oversees the storage bins and notifies Coop 2 when Crops must be picked up.

Because much of the land in the area served by Taxpayer is now used for other more valuable purposes, there is less need for a cooperative to market and process Crops in the region. As a result, Taxpayer plans to liquidate by selling its Remaining Operating Assets and then distribute the net proceeds of such sales to the members.

Taxpayer plans to sell all of its Remaining Operating Assets pursuant to a property purchase agreement entered into on [redacted]. All of the Remaining Operating Assets have been directly related to Taxpayer's historic business of marketing and processing Crops. Any gain from the sale would be characterized as capital gain, section 1231 or section 1245 gain. After selling all the Remaining Operating Assets, Taxpayer will distribute the net proceeds to the members.

Section 2 of the Article V of the Articles provides that all members have equal management (i.e., voting) power, and Section 3 provides that a Member's property rights and interests in the property of Taxpayer shall be determined by the ratio of such Member's net capital deduction at that time bears to the total net capital deductions from all members at that time. As used in the Articles, net capital deductions from any

Member means the Retains from such Member less the total capital repayments (i.e., Retain repayments to such Member).

At this point, sufficient money has been repaid to the members such that each member's net capital deduction is \$. Taxpayer repaid the last of the Retains in .

Taxpayer plans to allocate and distribute the net proceeds to members based on patronage which is defined by § 1388(a) as the value or quantity of business done with or for members. Taxpayer proposes to allocate dividends based on the quantity of Crops delivered to Taxpayer (Distribution Method). Taxpayer will determine the quantity of Crops delivered to Taxpayer based on records kept from through which show delivery of Crops to Taxpayer for those years. Taxpayer proposes to only use records from through , rather than for the entire existence of Taxpayer, because the current officers are unsure of the completeness, accuracy, and availability of Taxpayer's older records.

Based on the foregoing, Taxpayer requests the Service to rule that:

- (1) Taxpayer continues to be an exempt farmers' cooperative under § 521.
- (2) The amount realized on the sale of Taxpayer's Remaining Operating Assets (the Amount Realized), to the extent that it is not attributable to the Leased Premises, constitutes patronage-sourced income.
- (3) The Amount Realized, to the extent that it is not attributable to the Leased Premises, may be excluded from Taxpayer's gross income as a patronage dividend, pursuant to §§ 1382(b)(1) and 1382(f), when paid during the applicable payment period (§ 1382(d)), based upon Taxpayer's proposed Distribution Method.
- (4) The Amount Realized that relates to gain on the sale of the Leased Premises constitutes income from sources other than patronage pursuant to § 1.1382-3(c)(2) of the Income Tax Regulations.
- (5) The Amount Realized that relates to the Leased Premises may be excluded from Taxpayer's gross income as a nonpatronage distribution, pursuant to §§ 1382(c)(2)(A) and 1.1382-3(c)(3), when paid during the applicable payment period (§ 1382(d)), based upon the taxpayers proposed Distribution Method.
- (6) For purposes of determining patronage for the application of the Distribution Method, Taxpayer may exclude a member's delivery of Crops to Coop 2.
- (7) Taxpayer's use of records from forward, rather than for its entire existence, will not affect Taxpayer's status as a cooperative exempt from taxation under § 521 or Taxpayer's ability to deduct the Amount Realized paid to the members.

Section 521(a) provides that a farmers' cooperative described in § 521(b)(1) shall be exempt from taxes except as otherwise provided in part I of Subchapter T.

Section 521(b)(1) defines a tax exempt farmers' cooperative to include a farmers', fruit growers', or like associations organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or value of the products furnished by them, or (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them actual cost, plus necessary expenses.

Section 1.521-1(e) provides that an organization is not exempt from taxation under § 1.521-1 merely because it claims that it complies with the requirements prescribed therein. In order to establish its exemption, every organization claiming exemption must file a Form 1028. However, an organization which has been granted exemption under the provisions of the Internal Revenue Service Code 1939 or prior law may rely on that ruling, unless affected by substantive changes in the Internal Revenue Code of 1954 or any changes in the character, purposes, or methods of operation of the organization, and its is not necessary in such case for the organization to request a new determination as to its exempt status.

Section 521(b)(4) provides that exemption shall not be denied any association that markets the products of nonmembers in the amount the value of which does not exceed the value of the products marketed for members, or which purchases supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 percent of the value of all its purchases.

After _____, all of Taxpayer's income has been from nonmember sources. Accordingly, it has ceased to a farmers' cooperative under § 521. However, Taxpayer continues to be a nonexempt cooperative under subchapter T.

Section 1381(a)(2) provides that subchapter T applies to any corporation operating on a cooperative basis. In the instant case, Taxpayer represents that it has been operating on a cooperative basis from its incorporation and has filed federal income tax returns in accordance with its status as a cooperative.

Cooperatives are permitted to exclude patronage dividends from their taxable income under § 1382(b). Section 1388(a) defines a "patronage dividend," as, among other things, an amount paid to a patron of a cooperative which is determined by reference to the net earnings of the organization from business done with or for its

patrons. Section 1388(a) also states that a patronage dividend does not include any amount paid to a patron to the extent that such amount is out of earnings other than from business done with or for patrons.

In Rev. Rul. 69-576, 1969-2 C.B. 166, a nonexempt farmers' cooperative borrowed money from a bank for cooperatives (itself a cooperative) to finance the acquisition of agricultural supplies for resale to its members. The bank for cooperatives allocated and paid interest from its net earnings to the nonexempt farmers' cooperative which it in turn allocated to its members.

In determining whether the allocation was from patronage sources the ruling states:

The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income is from nonpatronage sources. Rev. Rul. 690-576 at 167.

The ruling concluded that in as much as the income received by the nonexempt cooperative from the bank for cooperatives resulted from a transaction that financed the acquisition of agricultural supplies which were sold to its members, thereby directly facilitating the accomplishment of the cooperative's marketing, purchasing, or service activities, the income was patronage sourced.

Section 1.1382-3(c)(2) defines income from sources other than patronage (nonpatronage income) to mean incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association such as income derived from lease of premises, from investment in securities, or from the sale or exchange of capital assets.

In St. Louis Bank for Cooperatives v. United States, 224 Ct. Cl. 289, 624 F.2d 1041 (Cl. Ct. 1980), the Court held that interest on demand deposits in farm credit banks or on loans to brokerage funds received by St. Louis Bank for Cooperatives was patronage sourced income. The Court stated that a particular item of income is patronage sourced when the transactions involved are directly related to the marketing, purchasing, or service activities of the cooperative association. 624 F.2d at 1045.

In Twin County Grocers, Inc. v. United States, 2 Cl. Ct. 657 (1983), a nonexempt cooperative was denied deductions for patronage dividends for interest on a certificate of deposit bought from a nonpatron bank because the dividend income was not patronage sourced. The court held that the relation of income activity to the cooperative's business was too tenuous.

Courts have ruled in several instances that income from corporations organized by cooperatives to conduct activities related to the cooperative business is patronage sourced. In Farmland Industries, 78 T.C.M. 846, 864 (1999), acq., AOD 2001-03 (citing Cotter & Co. v. United States, 765 F.2d 1102, 1106 (1985); Land O'Lakes, Inc. v. United States, 675 F.2d 988, 993 (8th Cir. 1982); Certified Grocers of Cal., Ltd. v. Commissioner, 88 T.C. 238, 243 (1987); Illinois Grain Corp. v. Commissioner, 87 T.C. 435, 459 (1986)), the taxpayer, a cooperative organized for the purpose of providing petroleum products to its patrons, sought to have the proceeds from the disposition of its stock in three subsidiaries classified as patronage-sourced income. In reaching its decision, the court stated that its task was to "determine whether each of the gains and losses at issue was realized in a transaction that was directly related to the cooperative enterprise, or in one which generated incidental income that contributed to the overall profitability of the cooperative but did not actually facilitate the accomplishment of the cooperative's marketing, purchasing, or servicing activities on behalf of its patrons," 78 T.C.M. at 870.

Emphasizing the need "to focus on the 'totality of the circumstances' and to view the business environment to which the income producing transaction is related," the Tax Court analyzed the reasons behind both the organization of the subsidiaries and their eventual disposition, 78 T.C.M. at 864, 865. First, it looked at whether the taxpayer's subsidiaries were organized to perform functions related to its cooperative enterprises. The subsidiaries had been organized to explore for, produce, and transport crude oil. The court determined that all of the subsidiaries were organized to perform functions related to the taxpayer's business and were not mere passive investments. Id. at 871.

In other cases, the direct relationship between the purpose of a cooperative business and its reasons for investing in a subsidiary were found to be dispositive on the question of whether income received from the subsidiary was patronage sourced. For example, in Astoria Plywood Corp. v. United States, 79-1 USTC 9197 (D. Or. 1979), the court found that the income derived by a plywood and veneer workers' cooperative from the cancellation of a lease on a veneer plant was patronage sourced, because the production of veneer was an integral part of the cooperative's business. In other words, the reason the cooperative leased the property to begin with had nothing to do with investing in real estate and everything to do with making veneer. Similarly, in Linnton Plywood Assoc. v. United States, 410 F.Supp. 1100 (D. Or. 1976), the court held that the dividends received by a plywood workers' cooperative from West Coast Adhesives, a glue supplier which the cooperative helped to organize in order to supply its adhesive needs, were patronage-sourced income, since glue is essential for the manufacture of

plywood, and the arrangement to produce the glue was reasonably related to the business done with or for the cooperative's patrons.

Section 1382(c) provides that in determining the taxable income of an organization described in § 1381(a)(1), there shall be allowed as a deduction (in addition to other deductions allowable under this chapter) (1) amounts paid during the taxable year as dividends on its capital stock; and (2) amounts paid during the payment period for the taxable year (A) in money, qualified written notices of allocation, or other property (except nonqualified written notices of allocation) on a patronage basis to patrons with respect to its earnings during such taxable year which are derived from business done with or for the United States or any of its agencies or from sources other than patronage.

Section 1.1382-3(c)(3) provides that in order that the deduction for amounts with respect to income derived from business done with or for the United States or any of its agencies or from sources other than patronage may be applicable, it is necessary that the amount sought to be deducted be paid on a patronage basis in proportion, insofar as is practicable, to the amount of business done by or for patrons during the period to which such income is attributable. For example, if capital gains are realized from the sale or exchange of capital assets acquired and disposed of during the taxable year, income realized from such gains must be paid to patrons of such year in proportion to the amount of business done by such patrons during the taxable year. Similarly, if capital gains are realized by the association from the sale or exchange of capital assets held for a period extending into more than one taxable year income realized from such gains must be paid, insofar as is practicable, to persons who were patrons during the taxable years in which the asset was owned by the association in proportion to the amount of business done by such patrons during such taxable years.

Section 1.1388-1(a)(1)(i) provides that the term "patronage dividend" means an amount paid by a cooperative organization subject to the provisions of subchapter T which is paid on the basis of the quantity or value of business done with or for such patron.

Accordingly, based on the foregoing representation of facts and discussion of law, we rule that:

(1) Taxpayer is no longer an exempt farmers' cooperative under § 521 but continues to be a nonexempt cooperative under subchapter T of the Internal Revenue Code

(2) The amount realized on the sale of Taxpayer's Remaining Operating Assets (the Amount Realized), to the extent that it is not attributable to the Leased Premises, constitutes patronage-sourced income.

(3) The Amount Realized, to the extent that it is not attributable to the Leased Premises, may be excluded from Taxpayer's gross income as a patronage dividend, pursuant to § 1382(b)(1), when paid during the applicable payment period (§ 1382(d)), based upon Taxpayer's proposed Distribution Method.

(4) The Amount Realized that relates to gain on the sale of the Leased Premises constitutes income from sources other than patronage pursuant to § 1.1382-3(c)(2).

(5) The Amount Realized that relates to the Leased Premises may not be excluded from Taxpayer's gross income as a nonpatronage distribution, pursuant to §§ 1382(c)(2)(A) and 1.1382-3(c)(3), when paid during the applicable payment period (§ 1382(d)), based upon the taxpayers proposed Distribution Method because Taxpayer is no longer a farmers' cooperative under § 521.

(6) For purposes of determining patronage for the application of the Distribution Method, Taxpayer may exclude a Member's delivery of Crops to Coop 2.

(7) Taxpayer's use of records from forward, rather than for its entire existence, will not affect Taxpayer's status as a nonexempt cooperative under subchapter T or Taxpayer's ability to deduct the Amount Realized (to the extent the amount is patronage sourced) paid to the members.

This ruling is directed only to the taxpayer that requested it. Under § 6110(k)(3) it may not be used or cited as precedent. No opinion is expressed or implied as to the proper allocation of the purchase price to the assets. In accordance with a power of attorney filed with the request, a copy of the ruling is being sent to your authorized representative

Sincerely yours,

Paul F. Handleman
Senior Technician Reviewer, Branch 5
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

cc: